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TAKING ACTION AGAINST AUCTIONS: THE THIRD CIRCUIT TASK FORCE REPORT

Jill E. Fisch*

INTRODUCTION

The Third Circuit has assumed a position of leadership in analyzing class action litigation.¹ Its reports, decisions and approaches have been influential.² Most recently, the Third Circuit created the Third Circuit Task Force on the Selection of Class Counsel (“Task Force”) to respond to new developments in the procedures for selecting and compensating lead counsel, including the lead counsel auction and the lead plaintiff provision of the Private Securities Litigation Reform Act (“PSLRA”).³ The product of this Task Force, the Third Circuit Task Force Report on Selection of Counsel (“Report”),⁴ continues the tradition, and we can expect it to enjoy similar influence.

The Report is a thoughtful carefully researched attempt to evaluate recent developments in the selection and compensation of class counsel and to provide guidelines for future decision making. Its primary focus is the two developments that motivated its preparation—the lead counsel auction and the lead plaintiff

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1. For example, the court’s decisions in *Lindy Bros. Builders v. Am. Radiator & Standard Sanitary Corp.*, 487 F.2d 161 (3d Cir. 1973) (“*Lindy I*”) and *Lindy Bros. Builders v. Am. Radiator & Standard Sanitary Corp.*, 540 F.2d 102 (3d Cir. 1976) (“*Lindy II*”) established a widely imitated prototype for application of the lodestar method of calculating attorneys fees. In 1985, the court formed a Task Force to consider the problems presented by the *Lindy* doctrine and to “begin[] the process of seeking solutions for the deficiencies in current practice.” Third Circuit Task Force, *Court Awarded Attorneys Fees*, reprinted in 108 F.R.D. 237, 274 (1985). The Task Force produced a highly regarded report on court awarded attorneys fees in class litigation. Recently, the court issued the first circuit court opinion to evaluate the lead counsel auction. In *re Cendant Corp. Litig.*, 264 F.3d 201, 270-71 (3d Cir. 2001).

2. See, e.g., Alan J. Tomkins & Thomas E. Willging, *TAXATION OF ATTORNEYS’ FEES: PRACTICES IN ENGLISH, ALASKAN, AND FEDERAL COURTS* 50-51 (1986) (describing *Lindy I* as providing one of “two most influential fee calculation methodologies that emerged” during first decade in which fee jurisprudence was developing); *Pennsylvania v. Delaware Valley Citizens’ Council for Clean Air*, 478 U.S. 546, 563 (1986) (citing lodestar approach, as developed through *Lindy I* and *Lindy II*, with approval); George B. Murr, *Analysis of the Valuation of Attorney Work Product According to the Market for Claims: Reformulating the Lodestar Method*, 31 LOY. U. CHI. L.J. 599, 614-18 (2000) (describing impact of 1985 Report on subsequent fee determinations).

3. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C.).

4. Third Circuit Task Force, *Report on Selection of Class Counsel (“Report”)*, available at <http://www.ca3.uscourts.gov/classcounsel/final%20report%20of%20third%20circuit%20task%20force.pdf>, reprinted in 74 TEMP. L. REV. 685 (2002). Subsequent references will use the pagination of the electronic version of the Report.

provision of the PSLRA.⁵ Its target audience is the bench and bar. In particular, the Report is designed to “assist[] courts, especially new judges, in determining how to proceed with appointment and compensation of counsel in class actions.”⁶

The Report’s conclusions are straightforward. With respect to auctions, the Report warns that their shortcomings are likely to outweigh their benefits.⁷ Similarly, although generally supportive of the empowered lead plaintiff approach, the Report concludes that it too is untested and, accordingly, “declines to recommend that the PSLRA model be extended to the appointment of counsel in other kinds of class actions, such as antitrust cases.”⁸ The Report concludes that courts should continue to employ traditional methods of selecting and compensating class counsel, “with significant reliance on private ordering.”⁹

Lead counsel auctions have enjoyed a fair amount of attention since the highly publicized auctions in *Cendant*¹⁰ and *Auction Houses*,¹¹ but there has been relatively little careful analysis of the auction methodology.¹² The Report makes a valuable contribution by conducting a thorough analysis and by reaching conclusions that are sound, clear and supported by the evidence. Drawing on an empirical analysis of auction cases,¹³ the Report identifies a variety of problems with the auction methodology, many of which are incompletely considered in existing auction decisions. Although the Report is unlikely to dissuade auction supporters, it should serve as a fair warning to others that auctions may not deliver on their promises. Moreover, many of the principles addressed in the Report can be extended beyond the auction context.

At 112 pages,¹⁴ the Report demonstrates impressive depth. At the same time, it leaves many questions unaddressed. The Report leaves for another day difficult normative assessments about the effectiveness of existing litigation levels and the extent to which judges’ opinions about the social value of litigation should inform their fee determinations. The Report also emphasizes securities and antitrust cases—areas in which there has already been extensive experimentation. Neither the lead counsel auction nor the empowered lead plaintiff model are well suited to mass torts or consumer fraud cases,¹⁵ yet the

5. See *id.* at 6 (observing that development of lead counsel auctions and empowered lead plaintiff model “gave rise to the appointment of this Task Force.”)

6. *Id.* at 12.

7. *Id.* at 49.

8. *Id.* at 94.

9. *Id.* at 18.

10. *In re Cendant Corp. Litig.*, 264 F.3d 201 (3d Cir. 2001).

11. *In re Auction Houses Antitrust Litig.*, 197 F.R.D. 71 (S.D.N.Y. 2000).

12. See generally Jill E. Fisch, *Lawyers on the Auction Block: Evaluating the Selection of Class Counsel by Auction*, 102 COLUM. L. REV. 650 (2002) (identifying limited scrutiny of auction approach and offering comprehensive analysis of auction methodology).

13. Laural L. Hooper and Marie Leary, *Auctioning the Role of Class Counsel in Class Action Cases: A Descriptive Study* (Federal Judicial Center 2001) (FJC Report).

14. See Report, *supra* note 4.

15. See Fisch, *supra* note 12, at 725-27.

limitations of private ordering in these areas suggest a need for continued innovation.

I. THE AUCTION ANALYSIS

The Report devotes the majority of its attention to the lead counsel auction. Reviewing the arguments concerning the auction procedure, the Report concludes that the dominant justification offered in favor of auctions is lower fee awards.¹⁶ The Report rejects this justification, finding both that the asserted benefit is “speculative” and that it is outweighed by the costs and risks of the auction procedure.¹⁷

The Report demonstrates that, as is true with many reform proposals, there are substantial gaps between theory and practice. The auction theory literature makes a variety of claims about efficiency and price production based on assumptions about the auction context.¹⁸ In the case of lead counsel auctions, assumptions about full information²⁰ and adequate competition²¹ are generally inappropriate. Even in situations in which these assumptions are accurate, auction results may deviate substantially from theoretical predictions.¹⁹ As a result, lead counsel auctions are unlikely to minimize legal fees.²²

Significantly, auctions cannot be defended by comparing the fee awards in recent auction cases to the benchmarks that are commonly used in class action litigation. Although a fee award of thirty-three percent or twenty-five percent is appropriate in some cases, benchmarks are often used as a substitute for a careful fee assessment. Ironically, the source of these benchmarks is the

16. Report, *supra* note 4, at 45 (“The major contention of auction proponents is that auctions replicate the market and result in savings to the class due to lower counsel fees”).

17. *Id.* at 49.

18. See Fisch, *supra* note 12, at 695-98 (describing auction theory literature).

19. Bid preparation requires the bidding firm to predict the expected recovery and the litigation effort that will be required to obtain that recovery. Both predictions involve a range of variables that are subject to considerable uncertainty. Among the issues that the firm must consider are the risk that it will be unable to establish liability, the difficulty calculating damages, and the potential that the defendant’s financial resources will be insufficient to satisfy a judgment. See, e.g., Brenda Sandburg, *CEO Cleared in Rare Stock Drop Trial*, THE RECORDER, Feb. 13, 2002 (observing that defense jury verdict in *Howard v. Everex Systems Inc.*, 92-3742 was likely to affect how plaintiffs’ lawyers value future cases).

20. To date, lead counsel auctions have been conducted in only a handful of cases, but many of those cases have involved a small number of few bids. See, e.g., Jill E. Fisch, *Aggregation, Auctions, and Other Developments in the Selection of Lead Counsel Under the PSLRA*, 64 LAW & CONTEMP. PROBS. 53, 90 (Spring/Summer 2001) (describing bidder participation); FJC Report, *supra* note 13 at 14-19 (detailing numbers of submitted bids in various auction cases).

21. See, e.g., Tilman Borgers and Christian Dustmann, *Strange Bids: Bidding Behavior in the United Kingdom’s Third Generation Spectrum Auction*, at 7-8 (working paper 2001) (demonstrating “large and systematic” deviations from theoretical predictions for bids in UK spectrum license auctions and consequently questioning whether auction results were efficient).

22. The Report goes on to reject the argument that fee minimization demonstrates the success of an auction. See Report, *supra* note 4, at 45. Indeed, the Report identifies a variety of negative consequences to the auction procedure. *Id.* In particular, the Report warns that auctions can sacrifice total recovery in favor of a lower fee award. *Id.*

marketplace to which auction proponents profess fidelity.²³ The standard percentage fee in traditional contingency fee agreements is one third.²⁴ Taking decisions like *Synthroid* at their word, contingency agreements in comparable individual lawsuits are an appropriate source of information on market rates.²⁵

At the same time, it is unreasonable to defend auction results by comparing them to statistical averages. Existing auction experience does not involve the "typical" class action. Instead, auctions have been used in strong well-publicized cases with substantial damages. Indeed, judges report that the cases most suitable for an auction are those in which liability is clear, information about the case is available in the public domain or from a criminal investigation, and damages are substantial, offering the potential for a very large recovery.²⁶ Cases with those characteristics appear unlikely to warrant a benchmark fee award of one third irrespective of the fee methodology employed by the court.

Moreover, courts already have the tools to avoid the wooden application of a fixed benchmark. It is unnecessary to resort to an auction to reduce fees in percentage terms. Decisions such as *Goldberger v. Integrated Resources, Inc.*,²⁷ *In re Prudential Insurance Co. of America Sales Practices Litigation*,²⁸ and *In re NASDAQ Market-Makers Antitrust Litigation*,²⁹ demonstrate the ability of courts to scrutinize fee applications and award fees far below the traditional benchmark without conducting an auction.

To the extent that judges rely on traditional benchmarks because they are reluctant to conduct a more rigorous inquiry, the auction offers little hope of improvement. The challenges of designing and implementing an appropriate auction procedure limit the ease with which an auction can be deployed.³⁰ Auctions are unlikely to generate competitive bids in precisely those cases in which the fee determination process is most difficult, such as cases in which the potential recovery is limited or where there is a substantial risk of nonrecovery. Many such cases attract only a single firm and, under the current system, are resolved by settlements and fee awards that receive little oversight or review.

23. See FJC Report, *supra* note 13, at 16 (finding that "the most common reason judges gave for employing bidding was to foster competition among counsel by replicating the private marketplace for legal services").

24. See Herbert M. Kritzer, *The Wages of Risk: The Returns of Contingency Fee Legal Practice*, 47 DEPAUL L. REV. 267, 285-86 (1998) (explaining "[o]ne-third is the 'standard' contingency fee figure" and reporting survey results showing ninety-two percent of lawyers employing a flat percentage used a rate of thirty-three percent).

25. See *In re Synthroid Mktg. Litig.*, 264 F.3d 712, 719 (7th Cir. 2001) (instructing courts to look to prevailing market rates in determining fee award and citing fee agreements signed by individual class members as one guide to such rates).

26. FJC Report, *supra* note 13, at 80.

27. 209 F.3d 43, 44-45 (2d Cir. 2000) (upholding fee award of four percent of recovery).

28. 106 F. Supp. 2d 721, 735-36 (D. N.J. 2000) (awarding fee of 4.8 percent of recovery in case involving "extraordinary risk").

29. 187 F.R.D. 465, 470 (S.D.N.Y. 1998) (awarding fee of fourteen percent of recovery).

30. See Paul Klemperer, *What Really Matters in Auction Design* 17 (Working Paper, June 21, 2000), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=237114 (explaining importance of auction design and risks of using inappropriately designed auction).

The Report correctly recognizes that these cases are unsuitable for an auction.³¹

Even the use of a carefully designed auction provides no assurance that the resulting fee is reasonable. The results of auction cases such as *Cendant* and *Auction Houses* suggest reason to question auction results.³² *Cendant* was a “simple case in terms of liability . . . and the case was settled at a very early stage, after little formal discovery.”³³ Nonetheless, the auction produced a fee of approximately \$10,861 per hour³⁴ or a lodestar multiplier of 45.75.³⁵ In *Auction Houses*, plaintiffs were able to benefit from a concurrent government investigation,³⁶ and the defendants were known to possess considerable financial resources. In addition, the *Auction Houses* bidders had access to an unusual amount of information about the case: interim lead counsel had hired experts to prepare studies of potential damages, which were distributed to all the bidding firms.³⁷ Still, the auction produced a fee of \$26.75 million for less than six months’ work. Perhaps more troubling was that the second highest bid, which would have won the auction if the Boies firm had not participated, would have resulted in a total fee of \$77 million.³⁸

II. THE BIGGER PICTURE

The Report’s detailed review of the auction process is a valuable service. More important, however, the Report recognizes that, by using an auction, courts may sacrifice class recovery in favor of minimizing legal fees.³⁹ In class litigation, results count. Any procedural tool or reform proposal must be evaluated in terms of its ability to further the objectives of the litigation. In representative litigation, in particular, judges must keep their eyes on the ball.

The relationship between counsel fees and litigation objectives has received insufficient attention. Although traditional fee analysis purports to consider the benefit provided to the plaintiff class,⁴⁰ existing methodologies offer courts little

31. Report, *supra* note 4, at 70-72.

32. See Fisch, *supra* note 21, at 84-88 (evaluating results in several auction cases).

33. In re *Cendant Corp. Litig.*, 264 F.3d 201, 285 (3d Cir. 2001).

34. Memorandum of Law by Corporation Counsel of the City of New York in Opposition to the Application of Lead Counsel for Attorneys’ Fees at 1, 9, In re *Cendant Corp. Litig.*, 191 F.R.D. 387 (D.N.J. 1998) (No. 98-CV-1664).

35. In re *Cendant*, 264 F.3d at 285.

36. In re *Auction Houses Antitrust Litig.*, 197 F.R.D. 71, 74 (S.D.N.Y. 2000).

37. *Id.*

38. See Fisch, *supra* note 12, at 684.

39. Report, *supra* note 4, at 45. From the perspective of plaintiff class, a total recovery of \$1 million of which counsel receives a fifty percent fee is more attractive than a total recovery of \$250,000, of which counsel receives ten percent. As in traditional litigation, the potential for the interests of lawyer and client to diverge increases as counsel’s percentage interest in the lawsuit decreases. Fee structures in which counsel receives a very low fee in percentage terms—particularly when that percentage is set *ex ante*—can create substantial agency problems. See Fisch, *supra* note 12, at 678-79.

40. Thomas E. Willging et al., *An Empirical Analysis of Rule 23 to Address the Rulemaking Challenges*, 71 N.Y.U. L. REV. 74, 162 (1996) (studying fee awards and identifying as indicators that the court considered class benefit “(1) use of percentage-of-recovery method, (2) any adjustments to

guidance as to how to incorporate an assessment of litigation value into their analysis.

Class actions serve a variety of objectives, including identification of wrongdoing, victim compensation and deterrence of misconduct.⁴¹ A court can compare the size of the recovery to the damages suffered by class victims to approximate the extent to which the recovery compensates class members. Similarly, although a court cannot predict the effect of a particular resolution on future wrongdoing, because wrongdoers are held accountable when they are required to pay in accordance with the damages that they inflict, recovery size can also be used as a proxy for deterrence effect.⁴²

Assessing the full social value of class litigation is more difficult. First, the benefits provided by the litigation must be measured against the litigation costs. Second, the private costs and benefits of litigation may diverge from the social costs and benefits.⁴³ This raises the question whether the judge, in monitoring representative litigation, should attempt merely to replicate the theoretical result of a traditional lawsuit or should consider broader societal interests. In particular, because the costs of litigation are frequently passed on in the market, it is not socially desirable to pursue every meritorious claim.⁴⁴ Third, a resolution may favor one objective over another.⁴⁵ How should a court choose between compensation and deterrence? Fourth, a court cannot assess the value of a particular case in isolation. The deterrence effect of a single judgment, for example, depends on how it affects the actual and perceived likelihood that future wrongdoers will be held accountable.⁴⁶

Finally, the court must consider the impact of its fee award on counsel's

lodestar amount based on results achieved, and (3) whether court considered any fee objections").

41. See, e.g., Stephen Calkins, *An Enforcement Official's Reflections on Antitrust Class Actions*, 39 ARIZ. L. REV. 413, 439-40 (1997) (identifying deterrence, compensation and identification of wrongdoing as social objectives of class action litigation).

42. But see James D. Cox, *Private Litigation and the Deterrence of Corporate Misconduct*, 60 LAW & CONTEMP. PROBS. 1 (Autumn 1997) (examining relationship between compensation and deterrence objectives of civil litigation and questioning whether compensation-based damages maximize deterrence). Moreover, from a deterrence perspective, damages need not be paid to the victims of misconduct. For deterrence purposes, the allocation of the recovery between class members, class counsel, and even the U.S. Treasury, is largely irrelevant. See Jill E. Fisch, *Class Action Reform, Qui Tam, and the Role of the Plaintiff*, 60 LAW & CONTEMP. PROBS. 167, 182-83 (Autumn 1997) (exploring alternative methods of calculating and awarding damages to further deterrence objective).

43. See, e.g., Kathryn E. Spier, *A Note on the Divergence between the Private and the Social Motive to Settle under a Negligence Rule*, 26 J. LEGAL STUD. 613, 613-15 (1997) (describing possible divergence between private incentives and social value of litigation).

44. See, e.g., Robert D. Cooter & Edward L. Rubin, *Orders and Incentives as Regulatory Methods: The Expedited Funds Availability Act of 1987*, 35 UCLA L. REV. 1115, 1172 (1988) (explaining that litigation expenses of civil enforcement will be borne by customers).

45. See Fisch, *supra* note 42, at 174-75 (demonstrating how increased focus on deterrence rather than compensation has led to structural changes in class litigation).

46. A full analysis of deterrence theory is beyond the scope of this review. See generally John T. Scholz, *Enforcement Policy and Corporate Misconduct: The Changing Perspective of Deterrence Theory*, 60 LAW & CONTEMP. PROBS. 253 (Summer 1997) (describing simple model of deterrence theory and complications identified through recent empirical research).

litigation incentives. As the Report recognizes, class litigation is lawyer driven.⁴⁷ Litigation decisions in common fund cases are influenced by counsel's financial incentives. Cases will not be litigated unless they offer a sufficient reward for entrepreneurial lawyers to act as private attorneys general.⁴⁸

Should a court consider social as well as private value in determining legal fees? To what extent should the court attempt to influence future litigation levels through the structure and size of its fee awards? The answers to these questions depend on normative judgments about the appropriate role of representative litigation and are clearly beyond the scope of the current Report. Nonetheless, beginning the inquiry would be a valuable endeavor. In particular, answers to these questions may resolve many of the current debates over process. For example, the argument that legal fees in class actions should be based on market rates presumes that fees should only reflect the value provided to the plaintiff class. Similarly, the auction procedure cannot be used to capture the social value of litigation. In comparison, the most compelling defense for ex post fee determinations is that they empower the judge to reflect both the public and the private benefits provided by the litigation in the fee award.

The extent to which the class action mechanism should be structured to increase deterrence is politically controversial.⁴⁹ Similarly, the appropriate balance between government and private enforcement is unclear.⁵⁰ In addition, a variety of factors affect the effectiveness of civil litigation in addressing wrongdoing. Nonetheless, legal reforms that reduce the viability of the class action create a legal climate that contributes to corporate misconduct. Some commentators, for example, have asserted that such reforms made the wrongdoing at Enron possible.⁵¹ Certainly the Enron experience demonstrates the inability of government regulation and criminal law to prevent the widespread dislocations caused by corporate misconduct. In a post-Enron world, the continued availability of the class action mechanism as a tool for victim

47. Report, *supra* note 4, at 3.

48. See Fisch, *supra* note 42, at 173-75 (describing financial incentives for class counsel to act as private attorneys general).

49. See, e.g., A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 929-30 (1999) (arguing that deterrence rather than compensation should be primary goal in securities fraud litigation).

50. See Fisch, *supra* note 42, at 198-201 (proposing extension of *qui tam* model to permit coordination between government and private enforcement efforts).

51. See, e.g., Stephen Labaton, *Now Who, Exactly, Got Us into This?*, N.Y. TIMES, Feb. 3, 2002, § 3, at 1, col. 5 (quoting Barbara Roper, director of investor protection at the Consumer Federation of America, arguing that Congress, by adopting the PSLRA, helped create environment that led to Enron-Anderson scandal.) The PSLRA enacted a variety of curbs on private civil litigation including a limitation on the liability exposure of auditors, a heightened pleading requirement, and a discovery stay during the pendency of a motion to dismiss. See Joel Seligman, *The Private Securities Reform Act of 1995*, 38 ARIZ. L. REV. 717, 725-31 (1996). Ironically, the PSLRA also enacted the statutory lead plaintiff provision. *Id.* at 726. Although the Report questions the feasibility of the empowered lead plaintiff model, I have argued elsewhere that the model offers substantial promise for addressing many issues in the selection and compensation of class counsel. See Fisch, *supra* note 12, at 710-14 (describing the advantages of the empowered lead plaintiff model).

compensation and deterrence of wrongdoing has become increasingly important.

If civil litigation is to serve broader social goals, these considerations must be reflected in class action fee awards. Repeated downward pressure on counsel fees weakens the driving force behind entrepreneurial litigation. Consequently, the impact of fee minimization can extend beyond any particular case. If fee awards are systematically too low, they will provide plaintiffs lawyers with insufficient incentives to litigate, resulting in suboptimal litigation levels. In the short run, lawyers will file fewer cases. In the long run, legal talent will be driven away from the plaintiffs bar to areas of greater financial reward. From a societal perspective, the resulting costs will be inadequate compensation and excessive levels of misconduct.

CONCLUSION

In its recent Report, the Third Circuit Task Force acknowledges the important role of the class action in identifying and rectifying public harms. The Report recognizes that well-intentioned reform efforts may interfere with the ability of class actions to perform that role. Although it may appear unduly conservative to demand that proponents of regulatory reform clearly demonstrate the efficacy of their proposals, the Report fairly judges that, with respect to lead counsel auctions, the supporters have not made their case.